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PASS FRB; USOECD; USEEC; USMTN ALSO FOR USMISSION

E.O. 11652: N/A
TAGS: EFIN, IT
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SUBJECT: BANK OF ITALY 1977 ANNUAL MEETING

1. /SUMMARY AND CONCLUSIONS:/ IN MAY 31 ADDRESS TO ANNUAL MEETING
OF BANK OF ITALY, GOVERNOR BAFFI REPEATED DIAGNOSIS OF ILLS OF
ITALIAN ECONOMY IN MANNER NOT MUCH DIFFERENT FROM LAST YEAR.
DESPITE 1976-77 GOI ECONOMIC STABILIZATION MEASURES IN MONETARY,
BUDGET AND LABOR FIELDS, HE STRESSED NEED TO DO MORE IN LATTER

TWO AREAS. REFERRING TO DEVELOPMENTS IN INTERNATIONAL ECONOMY BAFFI, NOT SURPRISINGLY, MADE APPEAL FOR FASTER NON-INFLATIONARY GROWTH AND MORE CURRENCY APPRECIATION BY CURRENT ACCOUNT SURPLUS COUNTRIES IN ORDER TO EASE ADJUSTMENT PROBLEM OF WEAKER COUNTRIES LIKE ITALY. INTERESTINGLY, US WAS MISSING FROM LIST OF COUNTRIES TO WHICH APPEAL WAS MADE, PROBABLY REFLECTING AWARENESS OF RECENT US PROJECTION OF LARGE 1977 CURRENT ACCOUNT DEFICIT AND GOOD RATE OF ECONOMIC GROWTH. ON QUESTION OF TRANSITIONAL FINANCING OF CONTINUING DEFICITS OF OIL-IMPORTERS, HE STRESSED LONGER TIME FRAME REQUIRED FOR ADJUSTMENT AND NEED FOR OFFICIAL FINANCING TO PLAY MORE IMPORTANT ROLE, IN PART TO REMOVE BURDEN OF RISK NOW BORNE BY INTERNATIONAL BANKING SYSTEM. BAFFI DETECTED TWO "VICIOUS CIRCLES" IN ITALY'S ECONOMY. ONE CONSISTED OF INADEQUATE SHIFT OF RESOURCES FROM CONSUMPTION TO INVESTMENT, INSUFFICIENT EXPORT GROWTH, AND CONTINUED BALANCE OF PAYMENTS RESTRAINT ON ECONOMIC GROWTH AND EMPLOYMENT. THIS CONDEMNED ITALY TO 3 PERCENT MAXIMUM GROWTH RATE IN NEXT FEW YEARS. HE ATTRIBUTED UNWILLINGNESS TO MAKE STRUCTURAL CHANGES TO SOCIAL AND POLITICAL FORCES WHICH WERE NOT PREPARED TO ACCEPT CUTS IN THEIR CONSUMPTION. SECOND VICIOUS CIRCLE WAS OFT-REPEATED ITALIAN BELIEF THAT EXCHANGE RATE DEPRECIATION, IN PRESENCE OF OPEN ECONOMY AND OF HIGHLY EFFECTIVE INDEXED WAGE SYSTEM, DID NOT HELP TRADE ACCOUNT MUCH AND TENDED TO FEED INFLATION. ADDRESSING TWO CURRENTLY HOT DOMESTIC ISSUES, I.E., HIGH NOMINAL INTEREST RATES AND STRUCTURAL FINANCIAL WEAKNESS OF ITALIAN BUSINESS, GOVERNOR OPPOSED ANY REDUCTION IN INTEREST RATES WHICH WAS NOT RELATED TO PROGRESS ON INFLATION FRONT OR WHICH DEPENDED ON FIXING INTEREST RATES ON DEPOSITS AT LEVELS WHICH WOULD DISCOURAGE SAVINGS. BAFFI'S APPROACH TO FINANCIAL

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PROBLEMS OF BUSINESS SEEMED OPEN TO INNOVATIVE METHODS OF SOLVING PROBLEM HE CONCENTRATED SOMEWHAT ON NEED TO STRENGTHEN LIMITED NUMBER OF LARGE FIRMS, WHOSE IMPROVED HEALTH WOULD THEN TRICKLE DOWN AND HELP SMALLER FIRMS. IF BANKING SYSTEM WAS TO BE INVOLVED IN THESE OPERATIONS, IT SHOULD BE ON TEMPORARY AND VOLUNTARY BASIS. AS CARLI DID BEFORE HIM, BAFFI LAMENTED INCREASING LOSS OF CONTROL OVER MONETARY EXPANSION BY CENTRAL BANK, DUE TO OVERRIDING ROLE EXERCISED BY TREASURY DEFICIT AND ACTIONS TAKEN BY PARLIAMENT AND POLITICAL PARTIES. MOST COMMENTATORS NOTED EVEN DRYER AND LESS POLEMICAL TONE OF ADDRESS THAN IN BAFFI'S FIRST ANNUAL MEETING SPEECH LAST YEAR. HOWEVER, MILAN FINANCIAL DAILY /24 ORE/ EDITORIAL CAUTIONED READERS TO PAY ATTENTION, NOT TO TONE, BUT TO SUBSTANCE OF SPEECH. AFTER SPEECH, POLITICAL PARTY SPOKESMEN GENERALLY GAVE HIGH MARKS TO BAFFI, WITH EACH ONE FINDING SOMETHING IN SPEECH WHICH COULD BE INTERPRETED AS SUPPORTING ECONOMIC POLICY POSITION OF THAT PARTY. PROPOSAL FOR INTERIM BOI APPOINTMENT OF TOP BANK MANAGER WHERE POLITICAL AGREEMENT COULD NOT BE REACHED ON NOMINATIONS WAS WIDELY APPLAUDED, WHILE BAFFI'S EULOGY OF ROLE OF BANKS IN ITALIAN

SYSTEM RECEIVED SOME CRITICISM. IN SUM, BAFFI SPEECH WILL BE
HELPFUL IN KEEPING PUBLIC FOCUS ON CONTINUING SERIOUS ECONOMIC
PROBLEMS, BUT BALL IS MAINLY IN COURT OF GOVERNMENT, POLITICAL
PARTIES, BUSINESS AND LABOR TO TAKE SPECIFIC ACTIONS
REQUIRED IN PURSUIT OF RESTORATION OF NON-INFLATIONARY
GROWTH. FOLLOWING PARAGRAPHS GIVE MORE DETAIL ON BAFFI ADDRESS.

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P R 011735Z JUN 77
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.....ADDRESS.

2. /FUNCTION OF CENTRAL BANK/. BAFFI LAMENTED THAT JOB OF
MANAGING BANK HAD CHANGED IN RECENT YEARS AND BECOME MORE
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BURDENSOME AND LESS GRATIFYING. BANK'S ROLE HAD DECLINED IN
THAT IT NO LONGER HAD AN IMPORTANT PART IN DECISION-MAKING
PROCESS FOR CONTROL OVER CREATION OF MONETARY BASE. HE STATED THAT
CREATION OF MONEY NOW REFLECTED SIZE OF PUBLIC DEFICIT AND OF
WAGE INCREASES. THUS, CONTROL OVER MONEY AGGREGATES, IN PARTICULAR
THROUGH USE OF DISCOUNT POLICY, HAS NEARLY CEASED AND BETTER
CONTROL AWAITS MORE RESTRICTIVE BUDGET AND INCOMES POLICIES.
ON OTHER HAND, BANK'S ROLE HAS GROWN AS AN ORGAN OF CREDIT POLICY
BECAUSE, WITH DIMINISHED FORMATION OF RISK CAPITAL, THERE HAS
BEEN INTENSIFICATION OF FINANCIAL INTERMEDIATION BY BANKS.

3. /INTERNATIONAL ECONOMY/. BAFFI POINTED OUT THAT ECONOMIC
EVOLUTION IN PRINCIPAL INDUSTRIALIZED NATIONS DURING 1976 WAS
CHARACTERIZED BY RECOVERY OF PRODUCTION AND SLOWING OF INFLATION.
HOWEVER, WHILE EMPLOYMENT GENERALLY INCREASED, THERE WAS NO
GENERAL RE-ABSORPTION OF UNEMPLOYED. RECOVERY WAS GENERALLY LED
BY CONSUMPTION, WHILE NEW INVESTMENT WAS MAINLY DIRECTED TOWARD
MORE CAPITAL INTENSIVE COMBINATION OF FACTORS OF PRODUCTION.
INVESTMENT WAS NOT SUFFICIENT TO PROMOTE NECESSARY RE-ALLOCATION
OF RESOURCES IMPOSED ON INDUSTRIALIZED NATIONS BY SHIFT IN RELATIVE
PRICES BETWEEN RAW MATERIALS AND FINISHED GOODS. REASONS FOR THE
TORPID INVESTMENT PERFORMANCE WAS PROBABLY HIGH LEVEL OF UNUSED
CAPACITY AND UNCERTAINTY ABOUT EVOLUTION OF DEMAND AND OF PRICES
DUE TO INCREASED WORLD-WIDE ECONOMIC INSTABILITY. FOREIGN
INVESTMENT ACTIVITY WAS ALSO AFFECTED BY MONETARY AND POLITICAL
INSTABILITY AND BY ABSORPTION OF FINANCIAL RESOURCES IN COVERING
BUDGET DEFICITS. WHERE COUNTRIES HAD SUCCEEDED IN SLOWING
INFLATION AND STRENGTHENING BALANCE OF PAYMENTS, IT HAD BEEN AT
COST OF INVESTMENT, ECONOMIC GROWTH AND EMPLOYMENT. THERE HAVE
BEEN WIDE DIFFERENCES AMONG COUNTRIES IN DEGREE OF SUCCESS IN
FIGHT AGAINST INFLATION. IN SOME COUNTRIES, ADJUSTMENT PROCESS
HAS BEEN PARTICULARLY DIFFICULT BECAUSE IT HAS NOT BEEN POSSIBLE
TO LIMIT RISE IN UNIT LABOR COSTS FOLLOWING WORSENING OF TERMS
OF TRADE DUE TO OIL CRISIS. BAFFI POINTED OUT THAT EVOLUTION OF
BALANCES OF PAYMENTS OF OIL IMPORTERS DEMONSTRATED THAT RE-
ABSORPTION OF OIL DEFICITS WILL TAKE LONGER THAN EARLIER FORESEEN,
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PRIMARILY BECAUSE OF SLOWER THAN EXPECTED PROGRESS BY IMPORTING
COUNTRIES IN DEVELOPING ALTERNATIVE ENERGY SOURCES AND IN
CONSERVING ENERGY, AND OF EXPORTING COUNTRIES IN ABSORBING SURPLUSES.

HE STATED THAT IF THERE WAS NOT A MORE SATISFACTORY DISTRIBUTION OF CURRENT ACCOUNT DEFICITS AMONG OIL-IMPORTING COUNTRIES BY THE MID-1980'S, FOREIGN DEBT PROBLEM WILL ASSUME CRITICAL DIMENSIONS. TO AVOID THIS, THOSE SURPLUS INDUSTRIAL COUNTRIES--JAPAN, GERMANY, THE NETHERLANDS AND SWITZERLAND--WHICH IN THREE YEARS HAVE ACCUMULATED

CURRENT ACCOUNT SURPLUSES OF DLR28 BILLION, MUST PURSUE ECONOMIC POLICIES AIMED AT REDUCING OF THEIR SURPLUS BY PERMITTING LDC'S AND WEAKER INDUSTRIAL COUNTRIES TO ACHIEVE STRONGER GROWTH IN THEIR VOLUME OF EXPORT.

4. IN THREE YEARS FOLLOWING OIL PRICE INCREASE, FINANCING OF CURRENT ACCOUNT DEFICITS HAS BEEN PRINCIPALLY SHORT-TERM THROUGH INTERMEDIATION OF INTERNATIONAL BANKING SYSTEM, AND PARTICULARLY BY AMERICAN BANKS WHICH HAVE ENJOYED PREFERENTIAL TREATMENT IN SHORT AND LONG-TERM INVESTMENTS BY OIL-EXPORTERS. HOWEVER, PROSPECT THAT THESE STRUCTURAL DEFICITS MIGHT CONTINUE FOR ANOTHER 10 YEARS OR SO UNDERLINES URGENCY OF RE-EXAMINING BURDEN IMPOSED ON BANKS BY THIS FORM OF FINANCING. PRESENT RELATIONSHIP BETWEEN PRIVATE AND OFFICIAL CREDIT AND BETWEEN SHORT-TERM AND LONG-TERM INSTRUMENTS MUST BE CHANGED. CONSENSUS HAS EMERGED THAT INTERNATIONAL MONETARY FUND SHOULD TAKE A GREATER PART IN FINANCING THESE DEFICITS. BAFFI ADDED THAT IMF WILL HAVE TO HAVE MORE FLEXIBLE ACCESS TO FUNDS TO FULFILL THIS ROLE. ALSO, EEC WILL HAVE TO DEVELOP LONG-TERM FINANCING SCHEMES.

5. BAFFI RECALLED THAT INTERIM COMMITTEE OF FUND HAD RECENTLY AGREED ON GUIDELINES FOR MONITORING EXCHANGE RATE POLICIES OF MEMBER COUNTRIES BUT ASSERTED THAT ARGUMENT FOR BRINGING ABOUT BALANCE OF PAYMENTS EQUILIBRIUM THROUGH EXCHANGE RATE ADJUSTMENTS HAD BEEN WEAKENED....

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OPIC-06 SP-02 LAB-04 EPG-02 SIL-01 OMB-01 NSC-05
SS-15 STR-04 CEA-01 L-03 ABF-01 AGR-10 PA-02
PRS-01 /133 W

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P R 011735Z JUN 77
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.....WEAKENED.

6. /EXCHANGE RATE/. BAFFI REVIEWED DEVELOPMENTS IN ITALIAN
FOREIGN EXCHANGE MARKET DURING 1976 TO PRESENT. HE DISTINGUISHED
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THREE FOREIGN EXCHANGE CRISES DURING LAST YEAR--IN JANUARY,
SETEMBER AND OCTOBER 1976--AND HE DESCRIBED IMPACT OF VARIOUS
MEASURES ADOPTED TO STABILIZE LIRA, GRADUAL EXPIRATION OF SOME
OF THESE MEASURES, AND SOME FACTORS ACCOUNTING FOR STRENGTHENING
FO LIRA SINCE END OF LAST YEAR. HE SAID THAT ITALY WAS CONTINUING
TO EXPERIENCE "AMPLE INFLOWS OF FOREIGN EXCHANGE." BAFFI ALSO
NOTED THAT FORWARD DISCOUNTS ON LIRA HAD COME DOWN, NOW REFLECTING
MAINLY INTEREST RATE DIFFERENTIAL AND NOT ANTICIPATED CURRENCY
DEPRECIATION, AND THAT DISCOUNT IN BLACK MARKET HAD DISAPPEARED.
IN SUMMARY, EFFECTI LIRA/DOLLAR EXCHANGE RATE DECLINED.
FROM HIGH OF 947 LIRE FIRST WEEK OF NOVEMBER (WHICH INCLUDED
COSTS OF PRIOR DEPOSIT AND FOREIGN EXCHANGE TAX) TO 902 LIRE
BY END OF JANUARY OF THIS YEAR AND TO ABOUT 885 AT PRESENT.

7. FAVORABLE FACTORS SINGLED OUT BY BAFFI WERE INFLOWS OF REPATRIATED CAPITAL, FOREIGN COMMERCIAL CREDIT TO ITALIAN IMPORTERS, AND SHORT-TERM BORROWINGS BY COMMERCIAL BANKS; WITH LATTER INDUCED EXCHANGE CONTROL REQUIREMENTS IMPOSED ON ITALIAN IMPORTERS AND EXPORTERS AS WELL AS BY TIGHT CREDIT AT HOME.

8. CONCERNING RECENT DEVELOPMENTS, BAFFI SAID THAT IMPACT ON RESERVES OF CURRENT ACCOUNT DEFICIT AND REVERSAL OF COMMERCIAL CREDIT FLOWS HAS BEEN DAMPENED BY GROWTH OF NET FOREIGN DEBTOR POSITION OF ITALIAN BANKS, WHICH HAVE SUBSTITUTED IN PART FOR MATURING COMMERCIAL CREDIT. THESE SHRT-TERM BANK BORROWINGS NOW EXCEED OFFICIAL FOREIGN EXCHANGE RESERVES BY DLR 2.2 BILLION. BAFFI SAID, HOWEVER, THAT PRECARIOUSNESS SUGGESTED BY THIS SITUATION IS ATTENUATED TO EXTENT THAT THESE BORROWINGS FINANCE SELF-LIQUIDATING CREDIT EXTENDED TO ITALIAN EXPORTERS AND THAT EXCHANGE CONTROLS AND TIGHT CREDIT POLICY CONTINUE TO PROVIDE INCENTIVE FOR SUCH CAPITAL INFLOWS.

9. BAFFI DREW ATTENTIO TO STRONG INTERACTION BETWEEN EXCHANGE RATE AND RATE OF INFLATION IN ITALY, WHOSE ECONOMY WAS CHARACTERIZED BY HIGH VOLUME OF INTERNATIONAL TRANSACTIONS AND HIGH LEVEL UNCLASSIFIED

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OF INDEXATION OF MONEY INCOMES. UNDER SUCH CONDITIONS, OVERLY PESSIMISTIC EXPECTATIONS MAY CAUSE EXCHANGE RATE TO OVERSHOOT. NEW EXCESSIVELY DEPRECIATED RATE MAY THEN BE VALIDATED BY RAPID ADJUSTMENT OF INTERNAL PRICE LEVEL.

10. BAFFI ALSO WARNED THAT EFFORTS TO CORRECT EXTERNAL IMBALANCE BY CURBING DOMESTIC DEMAND WOULD BE INEFFECTIVE IF THEY WERE NOT ACCOMPANIED BY CONTROL OF "DYNAMICS OF INCOMES "AND BY MORE EFFICIENT ALLOCATION OF RESOURCES. HE SAID THAT IF EMPLOYMENT WAS MAINTAINED AT LEVEL HIGHER THAN OUTPUT WOULD JUSTIFY, CONSEQUENT FALL IN PRODUCTIVITY AND RISE IN UNIT LABOR COSTS WOULD PARTLY NULLIFY EFFECTS OF RESTRICTIVE DEMAND MANAGEMENT IN CORRECTING BALANCE OF PAYMENTS CONSTRAINT ON GROWTH.

11. /ECONOMIC SITUATION/ BAFFI REVIEWD PROGRESS OF ITALIAN ECONOMIC RECOVERY DURING 1976, NOTING THAT HIGH LEVEL OF ACTIVITY AT COST OF A LARGE CURRENT ACCOUNT DEFICIT SHOWED ONCE AGAIN INABILITY OF SYTEM TO FOLLOW POLISCY OF STABILITY AND GROWTH AT SAME TIME. DURING COURSE OF YEAR NEW ECONOMIC STABILIZATION PROGRAM TOOK SHAPE. BUT PROBLEM OF LABOR COSTS HAS NOT BE SOLVED AGREEMENT REACHED ON PRODUCTIVITY BETWEEN UNIONS AND INDUSTRY, WHILE USEFUL IN AN EXPANDING ECONOMY, WILL HAVE LITTLE EFFECT IN PRESENT CIRCUMSTANCES OF MODEST GROWTH FORESEEN FOR THIS YEAR. VALUE OF GOVERNMENT'S PARTIAL ASSUMPTION OF EMPLOYER'S HEALTH INSURANCE COSTS ("FISCALIZATION") FINANCED THROUG VALUE-ADDED

TAX INCREASES WAS ERODED BY FAILURE TO OBTAIN RATIFICATION OF
BLOCK OF FEEDBACK THROUGH WAGE ESCALATOR OF TAX INCREASE.
THUS GOVERNMENT WAS UNABLE TO RECOVER UNENCUMBERED USE OF INDIRECT
TAX INCREASES AS DEMAND MANAGEMENT POLICY TOOL.

12. REGARDING BALANCE OF PAYMENTS ADJUSTMENT IN REAL TERMS,
BAFFI NOTED THAT IN THREE-YEAR PERIOD 1973 TO 1976, EXPORTS AND
IMPORTS OF GOODS AND SERVICE HAD INCREASED IN VOLUME BY 26
PERCENT AND 2 PERCENT, RESPECTIVELY. THUS, AFTER THREE YEARS
OF HIGH OIL PRICES, CURRENT ACCOUNT DEFICIT IN 1976 WAS EQUAL
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(NET OF INTEREST ON EXTERNAL DEBT) TO THAT OF 1973 BUT AT HIGHER
LEVEL OF OVERALL ECONOMIC ACTIVITY. THIS TRANSFER OF REAL RESOURCES
WAS ACHIEVED THROUGH ABRUPT REDUCTION IN GROWTH. NONETHLESS,
IN LONG RUN, ADJUSTMENT PROCESS REQUIRES IMPROVEMENT IN COM-
PETITIVE POSITION AND DEPENDS UPON ADEQUATE FLOW OF INVESTMENT
AND AN ACTIVE LABOR POLICY. IN PRESENT CIRCUMSTANCES, LOW AVERAGE
PRODUCTIVITY LIMITS EXPORT COMPETITIVENESS, FORCES RESTRICTIONS
ON DOMESTIC DEMAND, WHICH REDUCES PROFITS AND IMPEDES INVESTMENTS
NEEDED TO MODIFY ECONOMIC STRUCTURE. TO BREAK THIS "VISCIOUS
CIRCLE" POLICY MUST BE PURSUED TO SHIFT RESOURCES FROM PRIVATE
AND PUBLIC CONSUMPTION TO INVESTMENT. THESE POLICIES SHOULD
AIM AT WAGE RESTRAINT, REDUCTION IN PUBLIC SECTOR DEFICIT AND
INDUCE AN INCREASE IN FAMILY SAVINGS.

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.....SAVINGS.

13. IN AREA OF PUBLIC FINANCE, GOVERNOR BAFFI POINTED OUT
THAT IMPROVEMENT ACHIEVED IN PUBLIC SECTOR DEFICIT TO DATE HAD
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BEEN PRIMARILY THROUGH INCREASES IN REVENUES. NOW, ACTION MUST
ALSO BE TAKEN TO REDUCE EXPENDITURES. IN PARTICULAR, HE CALLED
FOR BETTER CONTROL OVER COST OF HEALTH SERVICES AND OTHER FORMS OF
INCOME REDISTRIBUTION THROUGH LOW PUBLIC SERVICE TARIFFS.

14. /BUSINESS' FINANCIAL STRUCTURE./ DEBATE NOW UNDER WAY
REGARDING FINANCIAL RESTRUCTURING OF BUSINESSES HAS IDENTIFIED MAIN
PROBLEMS AS INADEQUACY OF RISK CAPITAL AND EXCESSIVE LEVEL OF HIGH
COST SHORT-TERM INDEBTEDNESS. SUCCESS IN FIGHT AGAINST INFLATION
WOULD REDUCE INTEREST RATES AND FACILITATES DEBT RE-STRUCTURING
AND WOULD ALSO PERMIT REACTIVATION OF BOND MARKET. BUSINESSES
ABOVE ALL NEED NEW RISK CAPITAL. PRESENT INSUFFICIENCY IS
PRIMARILY DUE TO REAL PROBLEMS OF BUSINESSES BUT IS AGGRAVATED
BOTH BY GOVERNMENTAL ACTION (E.G., TAX DISINCENTIVES) AND BY
UNION-IMPOSED LIMITS ON FLEXIBLE USE OF FACTORS OF PRODUCTION.
MOST IMPORTANT FACTOR IS TAX DISCRIMINATION FAVORING DEBT OVER
RISK CAPITAL, BUT THERE IS ALSO LACK OF ADEQUATE STRUCTURE
OF INVESTOR INSTITUTIONS. WHEN THESE CONSTRAINTS HAVE BEEN
REMOVED, MOST BUSINESSES WILL BE ABLE TO OVERCOME THEIR DIFFI-
CULTIES.

15. HOWEVER, SMALL NUMBER OF LARGEST ENTERPRISES MAY NEED

SPECIAL ASSISTANCE WITH HELP FROM BANKS BASED ON RECOVERY PLAN AGREED TO BY WORKERS. CREDIT INSTITUTIONS COULD ASSIST IN THIS PROCESS THROUGH CREATION OF CONSORTIUMS OF UNDERWRITERS OR CONSTITUTION OF FINANCIAL CORPORATIONS WHOSE STATUTES WOULD FIX PRECISE CRITERIA TO FOLLOW IN FIELD OF EQUITY INVESTMENTS.

16. /INTEREST RATES./ BAFFI REJECTED CALLS FOR LOWER NOMINAL INTEREST RATES IN ABSENCE OF PROGRESS ON INFLATION AND OBJECTED TO LOWER RATES ON BANKS DEPOSITS WHICH WOULD PENALIZE SMALL SAVERS. HE SAID THAT LONG-TERM CREDIT MARKET HAD COLLAPSED BECAUSE OF INFLATION. LONG RATES WERE BELOW SHORT RATES BECAUSE OF RIGIDITIES AND INTERVENTION IN LONGTERM MARKET. HE CITED INDEXATION AS POSSIBLE MEANS OF INTRODUCING MORE FLEXIBILITY BETWEEN RATES ON MORTGAGE LOANS AND RATE OF INFLATION. FINALLY, LOWER NOMINAL UNCLASSIFIED

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INTEREST RATES WOULD BE INCONSISTENT WITH OBJECTIVES OF CREATING HIGHER AND MORE STABLE DEMAND FOR FINANCIAL ASSETS AND ATTRACTING CAPITAL FROM ABROAD.

17. /TREASURY FINANCING./ BAFFI RAISED THE QUESTION OF WHETHER SOME LIMITS OUGHT NOT TO BE SET ON BANK OF ITALY FINANCING OF TREASURY DEFICIT. HE SAID LOWER NOMINAL RATES OF INTEREST AND REDUCED INFLATION CANNOT BE ACHIEVED WITHOUT REDUCING AMOUNT OF DEFICIT FINANCED BY MONETARY BASE CREATION, WHICH HAS ACCOUNTED FOR 162 PERCENT OF TOTAL MONETARY BASE CREATION DURING LAST FIVE YEARS. BAFFI POINTED OUT THAT BANK IS NOT LIMITED IN AMOUNT OF BILLS OR OTHER TREASURY OBLIGATIONS IT MAY PURCHASE. HE SAID, "IN A CHAIN OF TENSE SOCIAL AND POLITICAL RELATIONSHIPS, THE CURRENCY REPRESENTS THE WEAK LINK AND MONETARY FINANCING OF THE TREASURY DEFICIT THE BREAKING POINT IN THIS LINK."

18. BAFFI SUGGESTED ADOPTION OF A RULE THAT WOULD PREVENT BANK OF ITALY FROM CAUSING DISTORTIONS IN CREDIT MARKETS THROUGH ITS PURCHASES OF TREASURY SECURITIES AND WOULD ALSO LIMIT AMOUNT OF THESE PURCHASES. FOR EXAMPLE, BANK MIGHT NOT BE PERMITTED TO PURCHASE TREASURY SECURITIES AT LESS THAN CURRENT OPEN-MARKET INTEREST RATES.

19. /THE CHOICE OF MONETARY INSTRUMENTS./ BAFFI CHARACTERIZED MONETARY REGULATION IN ITALY DURING PAST YEAR AS DEPENDING MAINLY ON COERCIVE INSTRUMENTS, I.E., ON RESERVE REQUIREMENTS, PRIOR DEPOSIT, PORTFOLIO CONSTRAINTS, AND CEILINGS ON BANK LENDING RATHER THAN OPEN-MARKET OPERATIONS. HE OBJECTED TO HAVING TO EMPLOY THESE NON-MARKET ORIENTED INSTRUMENTS SINCE THEY REDUCED COMPETITION AMONG BANKS AND DISTORTED CREDIT FLOWS AND RESOURCE ALLOCATION. HOWEVER, TOWARD END OF 1976, BANK HAD BEGUN TO OPERATE WITH GREATER FLEXIBILITY IN OPEN-MARKET, BY OFFERING TREASURY BILLS AT CURRENTLY COMPETITIVE PRICES INSTEAD OF AT PRICES SET AT PRECEDING BILL AUCTION. GARDNER

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Message Attributes

Automatic Decaptioning: X
Capture Date: 01-Jan-1994 12:00:00 am
Channel Indicators: n/a
Current Classification: UNCLASSIFIED
Concepts: BANKS, MEETINGS, MEETING REPORTS
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Copy: SINGLE
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Decaption Date: 01-Jan-1960 12:00:00 am
Decaption Note:
Disposition Action: n/a
Disposition Approved on Date:
Disposition Case Number: n/a
Disposition Comment:
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Disposition Event:
Disposition History: n/a
Disposition Reason:
Disposition Remarks:
Document Number: 1977ROME09061
Document Source: CORE
Document Unique ID: 00
Drafter: n/a
Enclosure: n/a
Executive Order: N/A
Errors: N/A
Expiration:
Film Number: D770195-0792
Format: TEL
From: ROME
Handling Restrictions: n/a
Image Path:
ISecure: 1
Legacy Key: link1977/newtext/t197706102/aaaadllg.tel
Line Count: 547
Litigation Code IDs:
Litigation Codes:
Litigation History:
Locator: TEXT ON-LINE, ON MICROFILM
Message ID: fbe10773-c288-dd11-92da-001cc4696bcc
Office: ACTION EUR
Original Classification: UNCLASSIFIED
Original Handling Restrictions: n/a
Original Previous Classification: n/a
Original Previous Handling Restrictions: n/a
Page Count: 10
Previous Channel Indicators: n/a
Previous Classification: n/a
Previous Handling Restrictions: n/a
Reference: n/a
Retention: 0
Review Action: RELEASED, APPROVED
Review Content Flags:
Review Date: 12-Oct-2004 12:00:00 am
Review Event:
Review Exemptions: n/a
Review Media Identifier:
Review Release Date: n/a
Review Release Event: n/a
Review Transfer Date:
Review Withdrawn Fields: n/a
SAS ID: 2001165
Secure: OPEN
Status: NATIVE
Subject: BANK OF ITALY 1977 ANNUAL MEETING
TAGS: EFIN, IT, BANK OF ITALY
To: STATE TRSY
Type: TE
vdkgvwkey: odb://SAS/SAS.dbo.SAS_Docs/fbe10773-c288-dd11-92da-001cc4696bcc
Review Markings:
Margaret P. Grafeld
Declassified/Released
US Department of State
EO Systematic Review
22 May 2009
Markings: Margaret P. Grafeld Declassified/Released US Department of State EO Systematic Review 22 May 2009